

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105**

**NOTICE OF PROPOSED ACTION AND
NOTICE OF PUBLIC HEARING**

May 30, 2006

RH03030726

SUBJECT OF HEARING

California Insurance Commissioner John Garamendi proposes to adopt the regulations described below after considering comments from the public. The Commissioner's regulations propose to amend Title 10, Chapter 5, Subchapter 3, Article 7.4 of the California Code of Regulations. The proposed regulations will interpret the provisions of Division 2, Part 1, Chapter 8.5 of the California Insurance Code (CIC), entitled "Earthquake Insurance."

AUTHORITY AND REFERENCE

The Commissioner proposes to adopt the proposed regulations under the authority of *CalFarm v. Deukmejian* (1989) 48 Cal.3d 805, 825 [258 Cal.Rptr. 161] and *20th Century v. Garamendi* (1994) 8 Cal. 4th 216, 280 [32 Cal.Rptr.2d 807], which recognize the Commissioner's implied authority to exercise those powers that may fairly be implied from the statute granting the powers.

An insurer is required to offer earthquake coverage to those policyholders who are issued a policy of residential property insurance. (CIC § 10081.) CIC section 10086.5 prohibits a rejection, cancellation or nonrenewal of a residential insurance policy for reasons related to a policyholder's acceptance of an offer of earthquake coverage. These regulations will prohibit the use of eligibility guidelines in earthquake or residential property insurance that negatively impact policyholders who wish to accept an offer of earthquake coverage. The proposed regulations will implement, interpret and make specific CIC sections 675, 676, 678, 1857, 1858, 1858.1, 1858.07, 1860.3, 1861.05, 10081, 10082, 10082.5, 10086.5, 10087, 10089.2, 12921 and 12926.

PUBLIC HEARING

The Commissioner will hold a public hearing to provide all interested persons an opportunity to present statements or arguments, either orally or in writing, with respect to this regulation, as follows:

Date and time: August 9, 2006 10:00 a.m.

Location: Department of Insurance Hearing Room
45 Fremont Street, 22nd Floor
San Francisco, CA 94105

The hearing will continue on the date noted above until all testimony has been submitted or 4:00 p.m., whichever is earlier.

PRESENTATION OF WRITTEN AND/OR ORAL COMMENTS; CONTACT PERSONS

All persons are invited to present oral and/or written comments at the scheduled hearing. Written comments not presented at the hearing must be addressed to the following contact person:

Mike Riordan, Staff Counsel
California Department of Insurance
Rate Enforcement Bureau
45 Fremont Street, 21st Floor
San Francisco, CA 94105
riordanm@insurance.ca.gov
Telephone: (415) 538-4226
Facsimile: (415) 904-5490

Questions regarding the hearing, comments, or the substance of the proposed action should be addressed to the above contact person. If the contact person is unavailable, inquiries may be sent to the backup contact person:

Lisbeth Landsman-Smith, Staff Counsel
California Department of Insurance
Rate Enforcement Bureau
300 Capitol Mall, 16th Floor
Sacramento, California 95814
landsmanl@insurance.ca.gov
Telephone: (916) 492-3561
Facsimile: (916) 324-1883

DEADLINE FOR WRITTEN COMMENTS

All written materials must be received by the Commissioner, c/o the contact person at the address listed above, by no later than **5:00 p.m. on August 9, 2006**. Any materials received after that time will not be considered.

COMMENTS TRANSMITTED BY ELECTRONIC COMMUNICATION

The Commissioner will accept written comments transmitted by e-mail, provided they are sent to the following e-mail address: riordanm@insurance.ca.gov or landsmanl@insurance.ca.gov. The Commissioner will also accept written comments transmitted by facsimile provided they are directed to the attention of the contact person listed above. All comments sent by facsimile must be directed to the attention of Mike Riordan using the following fax number: (415) 904-5490. Comments sent to other e-mail addresses or other facsimile numbers will not be accepted. Comments sent by e-mail or facsimile are subject to the deadline for written comments set forth above. Written comments shall be submitted by one method only.

ACCESS TO HEARING ROOMS

The facilities to be used for the public hearing are accessible to persons with mobility impairments. Persons with sight or hearing impairments are requested to notify the contact person (listed above) for this hearing in order to make special arrangements, if necessary.

ADVOCACY OR WITNESS FEES

Persons or groups representing the interests of consumers may be entitled to reasonable advocacy fees, witness fees, and other reasonable expenses, in accordance with the provisions of subchapter 4.5, title 10, of the California Code of Regulations, in connection with their participation in this matter. Persons interested in inquiring about the appropriate procedures should contact the Office of the Public Advisor at the following address:

California Department of Insurance
Office of the Public Advisor
300 Capitol Mall, 17th Floor
Sacramento, CA 95814
(916) 492-3559

A copy of any written materials submitted to the Public Advisor regarding this rulemaking must also be submitted to the contact person for this hearing, listed above. Please contact the Office of the Public Advisor for further information.

INFORMATIVE DIGEST

Summary of Existing Law and Policy Statement Overview

The proposed regulations will ensure that residential property insurance and earthquake insurance is fair, available and affordable for all Californians, including those Californians with residential property that poses a unique risk of loss due to earthquake. A brief description of the history of the mandatory earthquake offer statutes provides the context for, as well as the need for, the proposed regulations.

As set forth in the court's decision in the case of *Marina Green Homeowners Association v.*

State Farm Fire and Casualty Company, Chapter 8.5 of the CIC, entitled “Earthquake Insurance,” was enacted by the Legislature primarily as a result of insurance companies’ concerns about the doctrine of concurrent causation as it related to earthquakes. Specifically, the insurance industry was concerned about an increasing body of case law which suggested that the doctrine of concurrent causation made insurers liable for earthquake loss under an “all risk” insurance policy, even if those insurers listed earthquake loss as an excluded peril under the applicable policy. (*Marina Green Homeowners Assoc. v. State Farm Fire and Cas. Co.* (1994) 25 Cal.App.4th 200, 205 [30 Cal.Rptr.2d 364].) Chapter 8.5 was regarded as a compromise that would abrogate the doctrine of concurrent causation as it applies to earthquakes, thereby avoiding insurer insolvency in the event of a major catastrophe, while still making earthquake insurance available to all interested persons. (*Ibid.*)

Thus, in order to prevent the application of the concurrent causation doctrine to policies which expressly exclude earthquake losses, CIC section 10088 provided that “...no policy which by its terms does not cover the peril of earthquake ... shall be held to provide coverage for any loss or damage when earthquake is a proximate cause...”¹

Because CIC section 10088 largely shielded the “all risk” homeowners policy from claims for losses caused by earthquake, the Legislature recognized a need to ensure that homeowners could still obtain earthquake coverage. Thus, the Legislature identified a second purpose in drafting Chapter 8.5: to promote awareness of earthquake insurance by residential property owners and tenants by requiring insurers to offer that coverage. (Stats. 1984, ch. 916, § 2, p. 3073; see also *Williams v. State Farm Fire and Casualty Co.* (1990) 216 Cal.App. 3d 1540, 1544-45 [265 Cal.Rptr. 644].) The Legislature made it clear that no policy of residential property insurance could be issued in this state unless the insured were offered coverage for loss caused by the peril of earthquake. (CIC § 10081.) The Legislature’s mandatory earthquake offer statutes were established in 1984. In the years following 1984, the Legislature modified the mandatory earthquake offer statutes in an effort to preserve the availability of earthquake insurance for Californians.

Prior to the 1988 adoption of CIC section 10086.5, some insurers declined to insure earthquake risks that were deemed “extraordinary” by failing to issue residential property insurance policies to those homes that represented a substantial risk of earthquake.

Rejection and Cancellation of Policyholders That Accepted Offer of Earthquake

Up until the Legislature’s adoption of CIC section 10086.5 in 1988, the earthquake insurance law contemplated the rejection or cancellation of a policy of residential insurance by the insurer, but imposed no limitations on the insurer’s right to cancel or reject a policy. (*Williams v. State Farm Fire and Casualty Co.* (1990) 216 Cal.App.3d 1540, 1548 [265 Cal.Rptr. 644].) In 1988, the Legislature noted that many companies provided residential property insurance to an applicant, but cancelled or rejected that insurance if, at any time, the policyholder attempted to accept the

¹ The Legislature, under limited circumstances, provided that some perils causally linked to an earthquake would still be covered by the homeowners policy. CIC section 10088.5, for example, still requires every residential policy covering fire to cover the losses caused by a fire following an earthquake.

mandatory earthquake offer, based upon heightened earthquake eligibility criteria. (Sen. Rules Com., Off. of Sen. Floor Analyses, SB 1976 (1987-1988 Reg. Sess.) as amended April 21, 1988, p. 2.) In 1988, the Legislature enacted CIC section 10086.5 to prohibit this practice. (*Id.*)

With the enactment of section 10086.5, the Legislature limited an insurer's right to reject or cancel a residential property insurance policy in a manner other than as dictated by CIC section 675 et seq. (*Williams v. State Farm Fire and Casualty Co.* (1990) 216 Cal.App.3d 1540, 1548 [265 Cal.Rptr. 644].) CIC section 10086.5, as originally adopted in 1988, prohibited the cancellation or rejection of a residential property insurance policy after an offer of earthquake coverage was accepted, if the cancellation or rejection was solely because the insured accepted the offer of earthquake coverage. (Stats. 1988, ch. 279, § 1.)

Non-renewal of Policyholders That Accepted Offer of Earthquake

During the next two years, the Legislature observed that some insurers still attempted to avoid insuring certain earthquake risks. Though insurers were prohibited from rejecting or canceling homeowners policyholders that accepted the offer of earthquake at intake, some insurers non-renewed existing policyholders after the first policy term, thus avoiding covering the earthquake risk.

CIC section 10086.5, as amended by Senate Bill 2183 (1990 Reg. Sess.), prohibited the non-renewal of a policy of residential property insurance solely because the policyholder had accepted the offer of earthquake. (CIC § 10086.5, subd. (b).) This measure was designed to "close the last loophole in the earthquake mandatory offer provision." (Assem. Comm. on Fin. and Ins., Rep. on Sen. Bill No. 2183 (1990-1991 Reg. Sess.) as amended May 3, 1990, p.1.) Thus, as CIC section 10086.5, subdivision (b) currently reads: "An insurer shall not refuse to renew, reject or cancel a policy of residential property insurance after an offer of earthquake coverage is accepted solely because the insured has accepted that offer of earthquake coverage, except in cases in which the policy is terminated by the named insured."

As additional protection for consumers, Senate Bill 2183 also added an affirmative prohibition against underwriting guidelines that discriminate against persons who attempt to accept or continue earthquake coverage. That prohibition is now codified in CIC section 10086.5, subdivision (c).

With 10086.5, the Legislature Intended to Restrict Insurer Underwriting Practices

The Assembly Committee on Finance and Insurance observed that the "core issue posed by [Senate Bill 2183] for insurers is whether or not California law, at any point in the residential insuring transaction, affords insurers the ability to decline to insure a particular residential property based solely upon adverse property characteristics which make it especially susceptible to damaging loss in an earthquake." (Assem. Com. on Finance and Ins., Rep on Sen. Bill No. 2183 (1990-1991, Reg. Sess.) as proposed to be amended on May 3, 1990, p.2.) The ultimate adoption of Senate Bill 2183 and the resultant codification of CIC section 10086.5, subdivision (c), demonstrated the Legislature's intent to prohibit such a practice.

Subdivision (c) expressly provides that underwriting guidelines cannot be used in a manner that discriminates against persons who accept the mandatory earthquake offer. The Legislative intent behind section 10086.5 reaffirms what is already provided by the language of the statute; insurance companies are prohibited from rejecting, canceling, or nonrenewing residential policyholders because the insurer perceives that the policyholder's home presents an unusually high risk of loss due to an earthquake. Moreover, insurers are prohibited from using underwriting standards applicable to residential property insurance in such a way that negatively impacts persons who wish to accept the mandatory earthquake offer. (CIC § 10086.5, subd. (c).) This fact is, perhaps, most apparent from a review of the comments in opposition to the law, as reprinted in the report of the third and final reading of Senate Bill 2183. The bill analysis prepared for the third and final reading includes a summary of an insurer's opposition to the bill. The insurer opposed the bill because, as the insurer correctly points out, Senate Bill 2183 prevents an insurer "from nonrenewing a policy of homeowner's insurance where the policyholder has accepted an offer of earthquake insurance and it is determined that the risk is extraordinary." (Sen. Fin. & Ins. Com., 3d reading analysis of Sen. Bill No. 2183 (1990-1991 Reg. Sess.) as amended August 14, 1990, p.2.)

Effect of Proposed Action

The Proposed Regulations are Necessary to Implement, Interpret and Make Specific CIC § 10086.5 and the Related Earthquake Statutes

The Commissioner is aware that some insurers believe the mandatory earthquake offer statutes remain vague on the subject of permissible underwriting guidelines and that some insurance carriers continue to believe that CIC section 10086.5, subdivision (c) and its related provisions still permit insurers to refuse to insure certain residential properties with extraordinary earthquake risks. Specifically, some insurance carriers continue to use underwriting guidelines which specifically reject some residential property insurance applications, due to the subject property's unique risk of loss from earthquake. Thus, by creating eligibility criteria for a residential property insurance policy which denies coverage to certain earthquake risks, these insurers avoid making the mandatory offer of earthquake to those who own the property at unique risk.

Insurers who operate in this matter point to CIC section 10082, subdivision (b), which states, in part: "...nothing in this chapter shall require an insurer to issue a policy of residential property insurance except in accordance with the insurer's usual underwriting standards." Based upon this provision, some insurers argue that they are permitted to reject certain unique earthquake risks because such a practice is "in accordance with the insurer's usual underwriting standards." For this reason, some insurers believe that the prohibition against the use of underwriting eligibility standards that discriminate against earthquake risks does not apply to any underwriting guideline that the insurer believes to be a "usual underwriting standard." While some insurers have argued that this makes the underwriting restrictions of CIC section 10086.5 (c) ambiguous, the Commissioner has determined that such an argument is contrary to the express language and Legislative intent behind the mandatory earthquake offer.

Currently some insurers use underwriting eligibility guidelines that effectively exclude insurance coverage for homes with increased earthquake risks. For example, these insurers place foundation bolting requirements and retrofitting requirements in their homeowner's underwriting eligibility criteria, effectively "screening out" certain earthquake risks by refusing to issue homeowner's insurance to such risks in the first instance.

The purpose of these regulations is to implement, interpret and make specific Chapter 8.5 of the CIC, and specifically, those provisions of the CIC which recognize that earthquake insurance must be made available to all interested consumers without discriminating against consumers who have homes that present a unique risk of loss due to earthquake. Proposed regulation section 2399.0 identifies the purpose and scope of the proposed regulations. Section 2399.1 establishes specific examples of prohibited underwriting eligibility criteria, and recognizes the insurers' burden to demonstrate that any allegedly discriminatory underwriting guideline does not violate any provision of the CIC. By prohibiting the use of any eligibility guideline which discriminates against residential property owners who wish to accept an offer of earthquake coverage, the proposed regulations set forth effective tools to enforce the mandatory earthquake offer. At the same time, proposed regulation section 2399.2 recognizes the needs of the insurance industry to file adequate rates which contemplate the unique risks for this catastrophe insurance line. Finally, proposed regulation section 2399.3 emphasizes the Commissioner's intention to maximize the effectiveness of these proposed regulations.

PRE-NOTICE PUBLIC DISCUSSIONS OF PROPOSED REGULATIONS

The Commissioner has not scheduled a pre-notice public discussion for this rulemaking action. The proposed regulations do not involve complex proposals. Additionally, the proposed regulations do not represent a large number of proposals that might otherwise make review during the public comment period difficult. In accordance with Government Code section 11346.45, therefore, a pre-notice public discussion was not scheduled for this rulemaking action because the proposed regulations do not involve issues of complexity.

MANDATES ON LOCAL AGENCIES OR SCHOOL DISTRICTS OR COSTS WHICH MUST BE REIMBURSED PURSUANT TO GOVERNMENT CODE SECTIONS 17500 THROUGH 17630

The proposed regulations do not impose any mandate on local agencies or school districts. There are no costs to local agencies or school districts for which Part 7 (commencing with Section 17500) of Division 4 of the Government Code would require reimbursement.

COST OR SAVINGS TO ANY STATE AGENCY

The Commissioner has determined that the proposed regulations will result in no cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed, no other nondiscretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State.

ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE WITH OTHER STATES

The Commissioner has made an initial determination that the adoption of this regulation may have a significant statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The Commissioner has not considered proposed alternatives that would lessen any adverse economic impact on business and invites you to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses.
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses.
- (iii) The use of performance standards rather than prescriptive standards.
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

The types of businesses affected by the proposed regulations are insurers that transact residential property insurance in the State of California. The proposed regulations will require insurers to offer residential property insurance and earthquake insurance to all insurance applicants in a manner which does not discriminate against persons who own properties that pose a unique risk of loss due to earthquake. This may affect those businesses that have traditionally refused to insure certain residential properties, on grounds related to such properties' risk of earthquake loss. Insurers that have traditionally refused to insure certain residential properties under these circumstances, however, do not comply with the requirements of CIC section 10086.5. Any economic impact that this regulation may have on insurers that are not in compliance with CIC section 10086.5, therefore, is inescapable, given the relevant statutory provisions.

POTENTIAL COST IMPACT ON PRIVATE PERSONS OR BUSINESSES

The Department is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

EFFECT ON JOBS IN CALIFORNIA

The Commissioner is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of existing businesses, and the expansion of businesses currently operating in the State. The Commissioner does not foresee that the proposed regulations will have an impact on any of the above but invites interested parties to comment on this issue.

IMPACT ON HOUSING COSTS

While the proposed regulations are likely to increase the availability of residential property and earthquake insurance, the regulations will have no significant effect on housing costs.

ALTERNATIVES

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective and less burdensome to affected private persons than the proposed action. The purpose of the proposed regulations is to implement a statutory mandate. To date, no reasonable alternative to the proposed regulations is apparent. The Commissioner, however, invites public comment on alternatives to the regulation.

IMPACT ON SMALL BUSINESS

The matters proposed herein will affect insurance companies, and therefore will not affect small business. (See Gov. Code § 11342.610, subd. (b), para. (2).)

COMPARABLE FEDERAL LAW

There are no existing federal regulations or statutes comparable to the proposed regulations.

ACCESS TO THE TEXT OF REGULATIONS AND STATEMENT OF REASONS

The Commissioner has prepared an initial statement of reasons that sets forth the reasons for the proposed action. The Commissioner also has available all the information upon which this proposed action is based and the express terms of the proposed action. Upon request, the initial statement of reasons will be made available for inspection and copying. Requests for the initial statement of reasons or questions regarding this proceeding should be directed to the contact person listed above. Upon request, the final statement of reasons will be made available for inspection and copying once it has been prepared. Requests for the final statement of reasons should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the proposed regulations, the statement of reasons, the information upon which the proposed action is based, and any supplemental information contained in the rulemaking file, is available for inspection and copying **by prior appointment** at 45 Fremont Street, 21st Floor, San Francisco, California, 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday. Written requests for the rulemaking file or questions regarding this proceeding should be directed to the contact persons listed above.

FINAL STATEMENT OF REASONS

Upon **written or e-mail** request, the final statement of reasons will be made available for inspection and copying once it has been prepared. Written requests for the final statement of reasons should be directed to the contact person listed above.

AUTOMATIC MAILING

A copy of this notice, including the informative digest, which contains the general substance of the proposed regulations, will automatically be sent to all persons on the Commissioner's mailing list.

WEBSITE POSTINGS

Documents concerning this proceeding are available on the Department's website. To access them, go to <http://www.insurance.ca.gov>. Just to the left of the center of the page, click the heading 'Consumers.' In this section, scroll down until you see the subheading 'Regulatory Activity.' Click on the nearby 'Proposed Regulations — Search' link. When the 'Search or Browse for Documents for Proposed Regulations' screen appears, you may choose to find the documents either by conducting a search or by browsing for them by name.

To search, enter "RH03030726" (the Department's regulation file number for these regulations) in the 'Search for' field. Alternatively, search using as your search term the California Insurance Code number of a code section that the regulations implement (for instance, "10086.5"), or search by keyword ("earthquake," for example or "residential"). Then, click on the 'Submit' button to display links to the various filing documents.

To browse, click on the 'Browse All Regulations' button near the bottom of the screen. A list of the names of regulations for which documents are posted will appear. Find in the list the 'Regulations Implementing Nondiscrimination Provisions Of Insurance Code' link, and click it. Links to the documents associated with these regulations will then be displayed.

AVAILABILITY OF MODIFIED TEXT OF REGULATION

In response to public comment, the Commissioner may determine that changes to the proposal are appropriate. If those changes are sufficiently related to the original text, such that the public had adequate notice of the proposal, as amended, copies of the amended text will be sent to all persons who testified or presented comments at the public hearing or submitted written comments during the comment period, and to anyone who requested information regarding the proposal. Thereafter, the Commissioner will accept written comments, arguments, evidence and testimony, concerning the changes only, for a period of at least 15 days prior to adoption.

At least 45 days notice will be given if the changes are not sufficiently related to the original text that the public was adequately placed on notice that the change could result from the originally proposed regulatory action.

Dated: May 30, 2006

JOHN GARAMENDI
Insurance Commissioner

By _____/s/_____
Mike Riordan
Staff Counsel